PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
One North Wacker
Chicago, IL 60606
Direct phone (312) 298-3689

to: **Jim Odiorne**

date: **February 18, 2004**

from: **Marty Staehlin, Lead Actuary**

subject: **Premera Share Allocation**

Disclaimer

This memo is solely for the purpose of providing an initial indication to the Washington Office of the Insurance Commissioner (OIC) of the contents of PwC's final report on Actuarial Issues, including share allocation between Washington and Alaska. The memo is a preliminary draft in all respects and is subject to change. The contents of PwC's final report may vary from the materials contained herein. This draft report is intended to be used only by the Washington State OIC and it designated representatives. It is not intended to be used and may not be relied upon by any other party for any reason without the express written consent of PwC.

An actuarial allocation of value between parties is a complex analysis similar to a valuation over the entire historical horizon of the parties at interest. As such, its component parts are not separable and it is not necessarily susceptible to a partial analysis or a summary description. Slight changes to historical facts and circumstances could have a material effect on the resulting analysis, since the facts and circumstances, if appropriate over a long time period, can accumulate to significantly different results. In performing the actuarial allocation of value, PwC has considered the results of all its analyses and did not necessarily attribute disproportionate weightings to any particular situation or factor identified. Furthermore, selecting any portion of PwC's analysis, without considering all analyses, would create an incomplete view of the process underlying this report summary and may distort any resulting findings. The assumptions used in developing these results are subject to varying degrees of confidence.

Overview of Share Allocation

PwC has assessed the available data to develop a best estimate of the allocation of value between Washington and Alaska from an actuarial perspective. We note that a separate allocation formula has been developed by the Investment Banking team based on appropriate valuation principles. The following notes outline the process followed to develop our current best estimate of the appropriate share allocation for use in allocating the Premera funds available between Washington and Alaska from an actuarial perspective.

General Overview

The actuarial value from which the share allocation between Washington and Alaska was derived is comprised of three potential factors:

1. The historic surplus of the Premera not-for-profit companies, obtained from Premera, the Washington Office of the Insurance Commissioner, and the State Archives;

2. The future value of Premera profits on the current business-in-force, derived from materials prepared by Premera and evaluated by PwC;

3. Various other factors best termed additional considerations, including start-up costs that would be attributed to a company the size of Premera Alaska, economies of scale contributed by affiliation with the Washington business, and other considerations.

Historic Surplus Allocation

Important factors used in assessing the accumulation of surplus included:

- Underwriting Cash Flow, defined to be premiums less incurred claims less expenses;

- Investment income including interest and dividends, realized capital gains and unrealized capital gains (developed from surplus account detail over time);

- Other income/expense; and

- Federal income tax expense.

We note that in analyzing the data over the period from 1933 to 2002 it was clear that some recorded values were incorrect. We believe certain specific corrections to the historical data are required to gain an accurate understanding of the distribution of revenues and expenses between the states of Washington and Alaska over the historical time period and made such corrections in our analysis.

In addition to the reported cash flow information, we considered the likely start-up costs of a stand-alone entity in Alaska at the time Blue Cross Blue Shield of Washington began operations in that state. We also considered specific cost allocations by year and "smoothed" the data where appropriate.

Incorporation of Future Value of Premera[1]

The future value of Premera is difficult to gauge; the investment banking community has approaches to characterize the value of the company. From an actuarial view, the use of a projection to value future business must be tempered by the probability that the projection is a likely event. PwC and Blackstone have developed a revised projection that adjusts several of the assumptions in the management projection (from Premera). Management's projection shows a growth in net income from operations, also known as underwriting cash flow that is large by historic standards and includes no downturns. Although we recognize the current healthcare marketplace seems ripe for a sustained profit cycle, we believe the projected surpluses are aggressive. We have discounted future surpluses in our analysis.[2]

The resulting future values are added to the values derived from the historic surplus allocation to determine a preliminary share value.

Additional Considerations

In addition to the historic and future estimated surplus values, other factors are important in assessing the appropriate split of proceeds from an actuarial perspective. Although the calculation appears to be a stand-alone value, in point of fact, an actuarial assessment considers the financial history including the audit and tax analysis, the financial reporting analysis provided as a forecast, the pricing of products in the Washington marketplace, and the general interaction of all the data collected to date.

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[1] By its nature, the future value of Premera generally assumes a status quo projection of results. Premera has provided a projection in its Form A filing that generally forms the basis for PwC's future value of Premera. Premera filed a subsequent projection during the review process of initial OIC consultant's reports. PwC worked with the OIC's Investment Banking consultants (i.e., Blackstone) to analyze all projection materials provided.

[2] PwC reviewed available actuarial methodologies and standards of practice in the course of its work. Two specific comments are relevant as a result of this review. The first comment relates to the use (or not) of a valuation assumption distinguishing inherent risks between existing business versus new business. Premera's projection provided no such distinction. Further, the management of the large group, ASC, and government lines of business applies principles of risk assessment and analysis consistently across new and existing business. The transformation of the individual market in Washington between 1993 and 2000, and Premera's subsequent re-entry into the market produces an environment in which new business is more favorable in the individual line of business. The "favorable risk" of individual new business more than offsets the one line of business with new business risk, i.e., small group. For the above reasons, the increased complexity of separating existing business versus new business valuations is not necessary or appropriate for this engagement.

The second comment concerns the cost of capital, sometimes used in an appraisal of an insurance company's business. The initial allocation represents an allocation to separate foundations. To the extent subsequent capital needs would constrain either foundation, a cost of capital would be appropriate. All projections we reviewed created no such constraint and, therefore, all future capital would not be constrained. Thus, no separate cost of capital calculation is appropriate.

At least two factors affect our assessment of an appropriate distribution of proceeds between Washington and Alaska:

1. The Alaska business, historically, was not consistently of sufficient size to operate on a stand-alone basis. Development of such a health plan in Alaska required capital, which for all intents was loaned from Washington to Alaska, with Washington serving as the 90/10 parent for 50 years.

2. Alaska is a small state and outside the State Employees case, Premera-Alaska has a dominant market share that is capped as to upside profit potential. On the other hand, Premera-Washington has retooled its product portfolio and systems and stands poised to increase its market share and improve its ability to price its products consistent with the managed care networks used in the delivery of those new products. Premera management reiterated this perspective repeatedly during several separate interviews.

Actuarial Allocation

Taken in combination, we calculate that Washington's share of the split of proceeds from the conversion of Premera to a for-profit entity, should the conversion be approved, is 82% to 88%.